

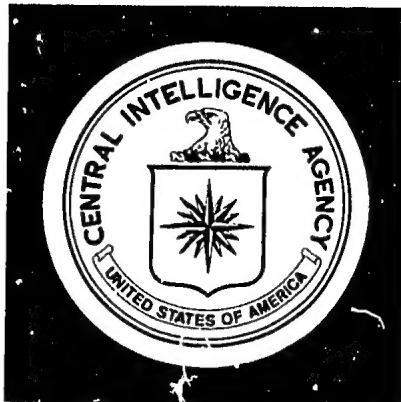
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**DIRECTORATE OF
INTELLIGENCE**

Intelligence Memorandum

*Eastern Europe's Debt to the West:
More Growth on the Installment Plan*

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
December 1972

INTELLIGENCE MEMORANDUM

EASTERN EUROPE'S DEBT TO THE WEST:
MORE GROWTH ON THE INSTALLMENT PLAN

INTRODUCTION

1. The debt of Eastern Europe¹ to the West on medium-term and long-term credit has jumped from some US \$600 million in 1960 to about \$3.8 billion at the end of 1971, most of the increase reflecting the rapid growth in purchases of Western machinery and equipment. Of the 1971 total, Romania owed roughly \$1 billion, Poland \$775 million, East Germany \$650 million, Hungary \$500 million, and Bulgaria and Czechoslovakia \$450 million each. This memorandum evaluates the burden of debt throughout Eastern Europe, looks at the wide variety of factors bearing on the credit situation in these countries, and analyzes export potential, import needs, and the trade and credit policies of both Western and Eastern Europe in projecting the indebtedness picture to the mid-1970s.

SUMMARY AND CONCLUSIONS

2. Among the East European countries, only Romania and Bulgaria at the moment are facing serious debt repayment pressures. In spite of recent debt rollovers, the Romanians probably will be running into another pinch some time in the 1970s. They might have to resort to more rescheduling or sharp cutbacks in imports, or both. The Bulgarians have less to worry about; they are only marginally dependent on imports from the West. At the other end, Poland, coming off trade surpluses with the West in 1970-71, and Hungary, with good export prospects and shrewd financial managers, have a good deal of room to raise imports and

1. Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, and Romania. Data for Yugoslavia are included where appropriate for comparison, but the complex Yugoslav debt situation will be treated in a separate memorandum.

Note: This memorandum was prepared by the Office of Economic Research.

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indebtedness in the 1970s. Czechoslovakia and East Germany also can absorb more debt, particularly if some lengthening of average terms can be achieved. For Eastern Europe as a whole, total indebtedness to the West probably will exceed \$6 billion by 1975 - more than \$2 billion over the present level.

3. Eastern Europe's debt and debt-servicing burden looks high compared with large debtors in the "Third World." Other factors, however, tend to improve Eastern Europe's relative position. These countries are far more advanced than the typical less developed country, are able to generate substantial domestic investment, and have the administrative machinery to control excessive increases in indebtedness. Moreover, many developing countries unlike Eastern Europe have substantial direct foreign investment, earnings from which are an additional claim on foreign exchange supply. Finally, the USSR, so far at least, has been willing to help countries avoid default (Bulgaria and Hungary) or just to tide them over temporary emergencies (Poland).

4. In spite of these factors, growing indebtedness to the West is of central long-term concern to Eastern Europe, as a possible future constraint on imports and on economic growth. The leaders in Eastern Europe, aside from Bulgaria, have begun to realize that growth is increasingly dependent on Western technology and credits and that continued large gains in exports, requiring new markets for manufactures, are an uphill struggle. This has led the East Europeans to seek out new channels of financing - in the United States and Japan and in the Eurodollar market - and at least to think about permitting foreign investment. Then too, the buildup of debt undoubtedly has provoked some of the renewed interest in integration and specialization within the Council for Mutual Economic Assistance (CEMA), although this certainly will not prevent increases in imports from the West.

5. Some of the East European countries may have to tighten the belt in the 1970s, but Western Europe - with the largest political stake in keeping trade with Eastern Europe growing - is likely to act to ease the pain. Major liberalizing steps may include spreading medium-term loans into very long-term obligations; guaranteeing West European joint investment with East European countries (those which allow it); and perhaps eventually even promoting regional institutional arrangements between the Common Market and CEMA to facilitate financing of trade and joint ventures. The East European countries would be apt to pick selectively out of such a grab bag. Romania would leap particularly at long-term loans; Poland and Hungary, not urgently needing to stretch out their obligations, might welcome the investment guarantees; and the Czechs and East Germans probably will remain suspicious of, and Bulgaria not particularly interested in, major new Western initiatives.

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DISCUSSION

The Debt Burden

6. Eastern Europe owed some \$3.8 billion on medium-term and long-term credits to the developed West at the end of 1971. Romania accounted for about \$1 billion; Poland, about \$775 billion²; East Germany, \$650 million; Hungary, \$500 million; and Czechoslovakia and Bulgaria, \$450 million apiece.³ These estimates are rough, and the structure of the debt is even less well known, making it hard to nail down the debt service burden.

7. The rough estimates of debt and debt servicing, however, coincide with the general views of West European bankers — and the managers of Soviet-owned banks in the West and of the Soviet insurance agency in Vienna. They uniformly agree on the rank order of debt burden and range of creditworthiness among the East European countries. As shown in Table 1, Bulgaria and Romania had the largest debt servicing relative to exports in 1971 and Czechoslovakia and Hungary the least.

8. Comparisons of debt servicing requirements among countries are both difficult and misleading. The best available figures — from the World Bank — exclude the part of the debt that is non-guaranteed private financing, often a large share. The relatively high 20% to 25% debt service ratios found for countries such as Mexico, Argentina, India, and Pakistan would probably rise steeply if all debts were reflected. In any case, the debt service ratio is generally admitted to be a doubtful indication by itself of comparative debt burdens. Mexico, for example, has avoided repayment problems and has consistently enjoyed favorable credit treatment in Western financing markets, even though its debt service ratio on public external debt alone ran well over 20% during most of the late 1960s. Other factors are equally important in assessing the debt burden — particularly export trends and potential, the size of foreign exchange reserves, and the term structure of the debt.

9. The term structure of the debt is important. Now that Bulgaria and Romania, with predominantly long-term indebtedness, have been able to run up relatively large debts, they have the least scope for stretching

2. Excluding PL-480 credits — some \$400 million — which call for only a small part to be repaid in hard currency; other very long-term and small obligations to the United States; and \$50 million in Mutual Security Act loans of 1957-59.

3. Except as otherwise indicated, all dollar figures in this memorandum have been converted at 1970 exchange rates. The realignment of exchange rates in 1971 resulted in an appreciation relative to the dollar of the values of the major currencies in which East-West trade is conducted and East European indebtedness is booked. Conversion at present exchange rates would raise the dollar figures by perhaps 10%.

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Table 1

**Eastern Europe: Estimated Debt and Debt-Service Ratios
with the Industrial West^a**

	<i>End-of-year</i>		<i>Debt Service</i>			<i>Debt Service Ratios</i>	
	<i>Debt 1970</i>	<i>1971</i>	<i>Exports 1971</i>	<i>Average 1970/71</i>	<i>Amortization 1970/71</i>	<i>Interest 1970/71</i>	<i>(Percent)</i>
<i>Million US \$</i>							
Total Eastern							
Europe	3,350	3,825	4,418	1,120	876	244	25
Bulgaria	400	450	268	115	85	30	43
Czechoslovakia	400	450	761	155	125	30	20
East Germany	600	650	1,050	260	223	37	25
Hungary	400	500	609	122	90	32	20
Poland	650	775	1,062	228	178	50	21
Romania	900	1,000	668	240	175	65	36
Yugoslavia	1,900	2,100	1,080^b	550	445	105	51^b
			2,180^c				25^c

a. Repayments and interest are figured on the average of 1970 and 1971 debt, except for Yugoslavia, for which actual data are available for the end of September 1971.

b. Hard currency commodity exports.

c. Exports including net earnings from invisibles less interest payments.

out their debt, short of periodic refinancing. Even if Bulgaria's average repayment period were substantially extended from 5 to 8 years, it would merely mean a lowering of the debt service-to-export ratio from 43% to 31% - still a very high figure. On the other hand, countries such as East Germany, with almost no long-term debt, could obtain quick symptomatic relief from a lengthening of terms. With an extension of average terms from 3 to 5 years, East Germany's servicing ratio would go from 25% to a seemingly comfortable 17%.

10. All factors considered, Bulgaria currently is in the worst financial shape in Eastern Europe; in 1971 the debt exceeded exports by nearly 70% and debt servicing was estimated to represent 43% of exports. Bulgaria's exports to the industrial West have been by far the lowest in Eastern Europe - both as a share of total exports (only 12% in 1971) and on a per capita basis (\$32 in 1971). Although exports to the West have grown impressively, very large gains would be needed even to approach a

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comfortable debt burden. On the other hand, Bulgaria has been able to count on Soviet support - indeed intervention - when it has been hard pressed to meet repayments.

11. Romania's debt in 1971 ran 50% above exports - almost two-thirds above exports if short-term debt is included. In 1970, Romania was able to obtain refinancing of part of its debts to West Germany. The People's Republic of China also helped out with a \$40 million hard currency credit. The picture has been substantially improved, however, by a rapid growth in Romanian exports to the West, at an average rate of 17% per year during 1966-71. Good export performance, aided by the refinancing in 1970, has been reflected in a steady reduction of Romania's debt service ratio, from more than 45% of exports in 1969 to about 35% in 1971. Another favorable factor is a gold reserve estimated at some \$125 million (at \$38 an ounce), out of a total gold and hard currency stock of about \$200 million at the end of 1971.

12. About 75% of Romania's medium-term and long-term indebtedness is on private, government-guaranteed credits from NATO countries, principally West Germany, France, and the United Kingdom. Another 15% is estimated to be on credits from non-NATO countries -- Austria, Japan, Sweden, and Switzerland -- and the remaining 10% on private non-guaranteed credits from Western lenders. Since 1965, more than two-fifths of the private, government-guaranteed credits have been long-term, with repayment periods ranging between 6 and 10 years -- some from date of delivery and some from date of putting the plant into operation. Interest rates have generally ranged between 5% and 8%.

13. The other countries -- Czechoslovakia, East Germany, Hungary, and Poland -- have stayed out of debt troubles in the 1960s. In all of these countries, debt servicing has been running between one-fifth and one-fourth of exports. Each, however, has special features, especially East Germany, with its liberal swing credit arrangements with West Germany, and Hungary, with its innovative dealings in the Eurodollar market. Exports to the West in all of these countries grew at an average annual rate of 10%-11% in 1966-70, except for Hungary (14.5%).

14. Czechoslovakia has had no known difficulty in handling its debt servicing. Debt to the West has grown rapidly since the Soviet invasion in 1968, partly reflecting increased imports of food and consumer goods to assuage the population. The structure of the debt leans heavily toward medium-term credit -- about three-fourths of the total debt in 1971. Much of the increase in indebtedness in recent years has been with financial institutions in Austria and Switzerland, which now account for about one-half of total indebtedness and finance a considerable part of

Czechoslovakia's purchases from other countries, notably West Germany. Political sensitivity on the question of indebtedness to West Germany may have influenced this development.

15. The East German debt position is anomalous in two ways -- in the very small amount of long-term credit involved, perhaps \$20 million outstanding out of some \$300 million in government-guaranteed credits, and in the availability of a substantial "swing" credit in trade with West Germany, now running at 585 million marks (about \$180 million at the current exchange rate) and likely to be raised in the near future⁴. Some unknown part of the "swing" is used, in effect, as medium-term credit. East Germany also draws on the Soviet-owned banks and other banks in Western Europe (in Switzerland, Austria, France, the United Kingdom, and Sweden, but not West Germany) for short-term and medium-term non-guaranteed credits. Many or most of the deliveries financed abroad do not appear in either East or West German statistics on inter-German trade, but are included in East German statistics on total imports. Medium-term credits from these sources probably run something like \$250 million at present. Because of the small share of long-term indebtedness, debt servicing -- now more than 25% of exports to the developed West -- is high relative to the size of the debt.

16. Hungary, with the most adept bankers and perhaps the most consistent and prudent economic policy, maintained by far the lowest ratio of debt to exports in Eastern Europe until 1969 -- the second year of the economic reform. Since then, extensive drawings on medium-term Eurodollar and other credits largely to finance purchases of equipment, coupled with a huge trade deficit in 1971, have brought the debt to \$500 million -- 82% of exports to the industrial West. The debt service burden, however, remains relatively light by East European standards, and a sharp reduction in the trade deficit with the West this year should reinforce Hungary's excellent credit rating in the West. So far, Hungary remains the only East European country to have floated Eurobond issues -- one in 1971 for \$25 million and another in 1972 for \$50 million. It has also been more active in borrowing from Western banking consortiums, arranging at least \$120 million in Eurodollar loans since 1968.

17. Poland's credit record is spotless. The debt service ratio also has been declining somewhat since 1969. Total indebtedness includes about \$725 million owed to Western Europe and Japan and about \$500 million to the United States, of which some \$400 million is for very long-term PL-480 credits, most of which is to be repaid in zlotys. In addition, the

4. The "swing" limit, set since 1968 at 25% of East German deliveries in the previous year, represents the ceiling for the East German deficit in the clearing account kept for trade between the Germanies. No provision is made for obligatory settlement of the "swing" balance.

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USSR reportedly extended a hard currency credit of \$100 million for purchases of meat in 1971-72. An extremely rapid growth of imports of capital equipment this year could have increased indebtedness to Western Europe and Japan to \$800 million by the end of July 1972. In addition, \$60 million in US credits from the Commodity Credit Corporation were drawn in fiscal year 1972, bringing the estimate of Poland's total hard currency indebtedness to around \$1 billion by mid-1972.

18. Even aside from the drawbacks of comparing debt servicing ratios, Eastern Europe's debt burden looks high relative to other debtor countries. However, most of these countries — certainly those most heavily in debt — are less developed countries. This and other special considerations set the debt picture in Eastern Europe apart from those elsewhere.

Distinctive Features

19. First, Eastern Europe is industrialized. Czechoslovakia (the Czech lands) and most of East Germany are old industrial areas. Important industries and well-developed handicrafts also were found in other East European areas before World War II, including the more developed areas in Yugoslavia — Slovenia and Croatia. Today, industry's contribution to gross national product (GNP) ranges from almost 40% in Romania, Hungary, and Poland to about 50% in Czechoslovakia, East Germany, and even Bulgaria. Per capita GNP in Eastern Europe runs from \$1,300 to \$1,600 in Bulgaria, Romania, Hungary, and Poland to about \$2,400 in Czechoslovakia and East Germany. Even the level in Bulgaria and Romania is higher than in all but a handful of less developed countries.

20. Second, East European governments generally have exercised effective control over investment, consumption, and imports, unlike many less developed countries. By contrast, Yugoslavia resembles Western less developed countries in this respect, not Eastern Europe. With this control, Eastern Europe has been able to generate — or force — substantial domestic investment and provide for remarkably steady industrial growth. Economic policy and the economies themselves have shown surprising stability even after abrupt changes in the leadership, as in Czechoslovakia, Poland, and East Germany in recent years. The regimes have demonstrated that they at least have the machinery for sound debt management.

21. Third, the resources of the USSR stand behind the East European countries. The USSR at various times has bailed out Hungary, Bulgaria, and Poland with hard currency loans when needed to meet repayments, or to meet their immediate needs. And the USSR, if asked, probably would do something for Romania as well. The strongly independent Romanians, however, are not likely to ask; as a last resort they have some gold. As

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a result of these stabilizing factors, Eastern Europe has met its debt payments on time, except for Romania, which asked for refinancing largely to spread out some shorter term obligations.

22. Finally, in evaluating Eastern Europe's debt, it should be remembered that many less developed countries, in addition to their debt to the industrial West, have substantial private direct foreign investments, earnings from which are an additional claim on foreign exchange supply. Except for a few projects in Yugoslavia and one joint ownership deal in Romania, there is no Western direct investment in Eastern Europe.⁵ Moreover, many less developed countries also have received Soviet credits, while the East European countries, aside from emergency Soviet assistance, have tended since the mid-1960s to become creditors rather than debtors to the USSR. This development mainly reflects Eastern Europe's sizable investments in the Soviet raw materials base since 1966. In short, relatively high debt service ratios for Eastern Europe do not indicate instability or irresponsibility, but rather lack of alternative sources of Western capital goods.

Prospects for Exports

23. East European exports to the industrial West will probably grow at a rate of between 7.5% and 10.5% a year during 1971-75. This projection is an updating of earlier studies based on the outlook (as of 1968-69) for East European output of exportable products and West European demand for this output.⁶ Taking account of the fairly uneven trade trends in the area in 1970-72, the current forecast gives a broader but slightly higher range of estimates than the earlier studies. It still indicates some decline from the high rates of the late 1960s. Past and projected rates of growth of exports are given in Table 2.

24. Romania and Poland, followed closely by Hungary, have the best medium-term prospects for expanding exports to the West. Although the slower growing product lines — agricultural products and raw materials — still account for a large share of sales, these countries have been rapidly boosting output and exports of intermediate industrial manufactures — metals, chemicals, and even textiles — that will continue to dominate trends in exports through 1975. Such products also make up a large share of East German and Czech exports, but the relatively slow growth in output will hold down exports to the West. These countries could eventually make major gains in sales of consumer goods and some items of machinery, but

5. Foreign investment in Yugoslavia, permitted on a partnership basis since 1967, still is only a small fraction of the capital inflow.

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SECRET**Table 2****Eastern Europe: Average Annual Rates of Growth of Exports**

	<i>Percent</i>					
	<i>1956-60</i>	<i>1961-65</i>	<i>1966-70</i>	<i>1971</i>	<i>Partial 1972</i>	<i>Projected 1971-75</i>
Total	9	9.5	11.5	9	13^a	7.5-10.5
Bulgaria	20	18	11	3	4	8.15
Czechoslovakia	10	8	11	2	3	5.8
East Germany	9	6	10	16	10	7.9
Hungary	6	12	15	.4	23	8.11
Poland	7	12	17	10	15	9.13
Romania	22	9	12	21	N.A.	9.12

a. Excluding Romania.

not enough by 1975 to yield faster rates of export growth than in the past decade. Bulgarian exports are hard to predict; growth has been and may continue to be erratic. Bulgaria's export growth has slowed from an average of 20% in the late 1950s to only 3%-4% in the past two years. On the other hand, output is booming in major exportable lines (chemicals and metal manufactures), and good prospects exist in sales of wine and out-of-season fruit.

25. Other studies - involving trade models - come up with overall forecasts that fall within the range of the present estimates, but differ substantially when individual countries and commodity trends are considered. A trade model developed for the UN's Economic Commission for Europe (reflecting data for 1957-67) gives alternative rates of 8.4% and 10.3% for exports to the West through 1980, but projects faster rates for the more developed East European countries, including East Germany and Czechoslovakia, than for the less developed countries. Another model, developed by Hungarian economists, projects a rate of 7.5% for all CEMA countries including the USSR, but predicts a sharp growth in agricultural exports and almost no growth for machinery through 1975 - exactly the opposite of trends in the 1960s.⁷

Probable Slowdown in Import Growth

26. In view of the projected drop in rates of growth for exports, the existing levels of indebtedness, and current trade deficits, the growth

7. These studies are discussed in the Appendix.

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of imports from the industrial West will almost certainly slow down in the 1970s for most East European countries. The evident exception is Poland, which should be able to carry out plans to accelerate the already fairly rapid growth of imports from the West from 64% in 1966-70 to 74% in 1971-75. The other countries have more or less explicitly indicated a sharp downturn in the growth of imports from the West. In the past, such indications have usually not been borne out, but the present outlook is different, particularly for Czechoslovakia, East Germany, and Romania. Hungary too will probably curtail the rise in imports. Bulgarian imports, having been kept down in the late 1960s, may grow somewhat faster in the 1970s.

27. The problem is that the dependence of the East European economies on imports from the West has been increasing, but that most of them will have difficulty financing a continuation of this trend. It is even unlikely that several of them can maintain the degree of dependence of economic growth on imports from the West of the past several years. Past trends reflect especially a sharp rise in imports of Western plant and equipment as a share of investment, and also increasing imports of raw materials and intermediate goods for the chemical, light, and – in some countries – the food processing industries, largely in support of rising domestic consumption.⁸ In short, imports from the industrial West have been important in upgrading East European technology and in maintaining economic stability. Imports from the industrial West, by commodity groups, are shown in Table 3.

28. In compiling Table 4, it was assumed that economic growth will continue at the same rates as in 1966-70 and that increments in imports from the West will bear the same relation to increments in the national products as in 1966-70. This yields a much more conservative projection for imports than would be obtained by projecting past trends.

29. Declines in rates of growth of imports during 1971-75 compared with 1966-70, overall and for all countries except Bulgaria, are shown in Table 4. Import growth at even these moderate rates probably would create balance-of-payments problems for Romania, Czechoslovakia, East Germany, and Bulgaria. Actual imports in these countries may, therefore, grow more slowly than the rates shown in Table 4. On the other hand, Poland and Hungary should be able to increase imports faster than shown in Table 4. These judgments clearly emerge from looking at the indebtedness that would result by 1975 from setting the projected rates of growth of exports against these import rates.

8. This is shown for Hungary – and projected to 1975 – in an interesting article discussed in the Appendix.

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Table 3
Eastern Europe: Imports from the Industrial West, by Commodity Group^a

	<i>Foodstuffs, Fats, and Oils</i>	<i>Raw Materials, Including Fuels</i>	<i>Chemicals</i>	<i>Intermediate Manufactures</i>	<i>Machinery and Transport Equipment</i>	<i>Consumer and Miscellaneous Manufactures</i>	<i>Total</i>
Thousand US \$							
1960	204,092	180,913	128,930	409,409	262,407	45,057	1,230,808
1965	364,706	244,142	269,617	464,470	547,394	76,764	1,967,093
1970	391,427	385,617	492,937	934,749	1,186,117	173,941	3,564,788
Percent of Total							
1960	17	15	10	33	21	4	100
1965	18	12	14	24	28	4	100
1970	11	11	14	26	33	5	100
Growth (Index 1960 = 100)							
1960	100	100	100	100	100	100	100
1965	179	135	209	113	209	170	160
1970	192	213	382	228	452	386	290

a. Data are from OECD publications, and total imports in general are lower, for a variety of reasons, than similar data from official East European sources.

Table 4
Eastern Europe: Average Annual Rates of Growth of Imports

					<i>Partial 1972</i>	<i>Hypothetical 1971-75^a</i>	<i>Percent</i>
	<i>1956-60</i>	<i>1961-65</i>	<i>1966-70</i>	<i>1971</i>			
Bulgaria	26 ^b	23	6	-1	-16	6	
Czechoslovakia	16	8	13	2	-3	9	
East Germany	9	6	15	5	25	10	
Hungary	3	10	13	21	-5	9	
Poland	12	5	10	14	45	8	
Romania	20	19	17	8	N.A.	11	

a. Projection based on past growth of GNP.

b. 1957-60.

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SECRET**Implications for Indebtedness**

30. The projections shown in Table 2 for exports, even using the higher estimates, and for imports, calculated under conservative assumptions concerning their relationship to economic growth, result for most countries in large cumulative trade deficits. Poland, however, shows a substantial surplus, and Hungary, a comfortable deficit.

31. These cumulative deficits imply an increase in indebtedness to the West and in debt service ratios (see Table 5). Trade deficits are only approximate measures of increases in medium-term and long-term indebtedness. Differences among countries in reporting imports,⁹ increases in short-term credits, and changing balances on net invisibles, all would affect a more complete and precise calculation of indebtedness. But the orders of magnitude are reliable enough to lead to some clear conclusions. It is evident that Poland will have the greatest flexibility and that Hungary can cope with the situation, but others may hesitate to get into debt so deeply.

32. If the same relationship as in recent years between debt, debt servicing, and exports were roughly maintained, East European indebtedness would reach about \$5.8 billion by 1975, using the higher of the two export projections from Table 2. More likely, the debt will exceed \$6 billion, given a lengthening of average terms and some scope for increasing debt service burdens for several countries. Still, this figure - some \$1 billion less than the figure in Table 5¹⁰ - would mean on the average not only a slower growth of imports but also some reduction in the contribution of imports from the West to economic growth. In Czechoslovakia and East Germany this adjustment could be painful. Hungary and Poland, however, will be able to increase their reliance on Western imports and their rates of growth without incurring overly large debts. Planned Polish imports and exports in 1971-75 imply a slight net decrease in indebtedness (to \$750 million, compared with \$775 million in 1971) and a debt-service ratio of only about 15% by 1975. But if Warsaw decides to increase considerably its indebtedness, it can do so without difficulty.

33. There is no reliable basis for predicting the limits to indebtedness for the other East European countries. The judgment that debt service ratios as high as projected in Table 5 will probably not be allowed to occur is not based mainly on doubts as to the ability of these countries to handle repayment and still less on any question as to the willingness of West

9. Poland, East Germany, and probably Bulgaria report imports f.o.b. the border of the exporting country as stated in their statistical yearbooks. Hungary reports c.i.f., also as stated. Czechoslovakia apparently reports at approximately c.i.f., contrary to stated procedure, and Romania probably continues to report at contract prices as last stated in 1964.

10. Which excludes a net debt for Poland.

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SECRET**Table 5****Eastern Europe: Cumulative Trade Deficits in 1971-75
and Implied Indebtedness and Debt Service Ratios in 1975**

<i>Indebtedness End of 1970</i>	<i>Cumulative Trade Balance 1971-75^a</i>	<i>Implied Indebtedness 1975</i>	<i>Related Debt Service Ratios 1975 (Percent)</i>
<i>Million US \$^b</i>			
Total	3,350	-3,088	7,170
Bulgaria	400	-306	706
Czechoslovakia	400	-1,029	1,429
East Germany	600	-1,286	1,886
Hungary	400	-272	672
Poland ^d	^{650^e}	+1,382	
Romania	900	-1,577	2,477

a. Using the higher of the two rates of increase projected for exports given on page 9, and the projection for imports given on page 11.

b. At 1970 exchange rates. Projected exports used in calculating debt and debt-service ratios are also computed at 1970 exchange rates.

c. Even at the lower rate projected for exports the debt-service ratio would rise only to 30%.

d. Poland's cumulative trade surplus is not included in implied indebtedness. If the policy indebtedness suggested by Poland's own trade plans were added (\$750 million in 1975), the total would be \$7,920 million.

e. Excluding PL-480 debts.

European banks and governments to help out where necessary. Rather, the judgment stems mainly from the recognition by East European leaders (and by the Soviet government, the silent guarantor of East European debt) that deficits can hardly accumulate indefinitely at these rates. Such projections, in short, serve to emphasize the policy considerations that have already moved the East European governments to look for other ways of maintaining economic growth and stability. These ways include further "integration" within CEMA, encouragement to Western firms to become joint investors in East European projects, and pressure on Western governments for concessions on quotas, tariffs, and interest rates.

Eastern Europe's Debt Policy

34. The East European regimes have clearly become concerned over their growing indebtedness as an eventual constraint on imports from the West and on economic growth. This is not much of a problem for Bulgaria, whose dependence on imports from the West is small, and its relatively

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high debt service ratio is accordingly not a matter of much concern to the regime, in spite of Soviet chiding. For Romania, on the other hand, the size and growth of indebtedness to the West has undoubtedly become a central issue of long-term economic policy. The economic motive usually cited for Romania's recent application to join the International Monetary Fund is to become eligible for support from the Fund and for long-term development credits from the World Bank. The same motive doubtless took Romania into the CEMA Investment Bank in early 1971, after long consideration, and made it generally more cooperative with the USSR and the CEMA organizations.

35. East Germany and Czechoslovakia, with much lower debt service ratios, are nevertheless anxious about future balance-of-payments deficits. As explained earlier, they expanded indebtedness rapidly in the late 1960s, mainly on medium term, to carry out policies given a high priority by the leaders, and could easily increase further their long-term debt. But both can see growing difficulties ahead in increasing exports to the West, and neither is disposed to push tourism or direct Western investment.

36. East Germany under Ulbricht ran up deficits - also with the USSR - in the hope of completing rapidly the creation of up-to-date petrochemical and electronic industries, while rebuilding the old centers of major cities. Ulbricht's inflexibility in pursuing this goal put a majority of the Politburo against him and apparently contributed to his replacement in 1971. His successor, Erich Honecker, battled unsuccessfully for a year to ease reliance on Western -- especially West German -- credit. His regime will be able to push ahead with present growth plans by getting substantial additional credit from West Germany, only too ready to help, and by drawing much more heavily - once recognition is achieved - on long-term credit from other Western countries. But the debt question, particularly over the longer term, still is the subject of lively debate and evident uneasiness.

37. Czechoslovakia went into debt rapidly after the Soviet invasion, with the obvious intent of propping up the economy to help assure domestic tranquility. This still appears to be a highly desirable policy for Czechoslovakia's uneasy leader Gustav Husak. And even though the medium-term outlook for increasing exports is far from good, Czechoslovakia can surely boost imports for some years, particularly after formal relations are established with West Germany, thus weakening Czech inhibitions against drawing more heavily on West German long-term credit.

38. Hungary and Poland, with much more room for maneuver, are also conscious of, but basically optimistic about, the long-term credit problem. The Gierek regime is resolved to modernize the economy in order

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to raise the lagging growth of labor productivity and provide the fuller life for the disgruntled Polish workers. The Hungarian leaders, who began the 1970s in an ebullient mood, congratulating themselves on the success of their unique economic reform, received a setback in 1971, when imports from the West soared beyond expectation and exports actually dropped a little. But the leaders did not overreact; they held fast against an abrupt deflationary policy and accepted the prospect of running deficits with the West for two or three years while the economy adjusts.

39. These differences in outlook toward trade with the West may well have contributed to differences in approach on the question of "economic integration" within CEMA. There is really no basis, however, for judging to what extent Czechoslovakia and East Germany see "integration" as an eventual alternative to becoming more and more reliant on the world market and to what extent the cooler approach of Poland is explained by favorable prospects for expanding imports from the West. But, for those countries most wary about possible credit problems in the West in this decade, there certainly will be a tendency to make what they can out of the CEMA trade. Even the Romanians have warmed up a little to the work of the CEMA commissions.

Western Europe's Stake

40. For West European governments, the eventual "crunch" in East-West trade is also a matter of obvious interest, but, in their case, political motives appear clearly uppermost. Although responsive to the interests of industry and banks in the expansion and stability of the trade, they realize that West European growth is not likely to depend much on the trade even over the longer run. For West Germany, the biggest trader and creditor, and for France and other major West European countries, the amounts risked in government credit guarantees can hardly appear large when weighed against the political stakes in closer relations with the East. They recognize that a breakdown in East-West trade, or even a reduction in its importance, could have serious political consequences for Europe.

41. Accordingly, it seems likely that West European governments and economic establishments will do all they can — indeed whatever they need to do — to keep the trade with Eastern Europe growing. Steps that may be taken by the late 1970s include substantial refinancing of medium-term indebtedness on a very long-term basis, perhaps with subsidized interest rates; guaranteeing West European capital investment in those East European countries that allow such investment; and giving special consideration under quotas and perhaps under tariffs for West European imports arising out of Western investment and other "joint ventures." The United States too, has been talking about insuring US business investments in Eastern Europe.

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42. In general, however, Western Europe is likely, as in the past, to set the pace for other industrial countries in the treatment of trade with Eastern Europe. For the United States, Japan, and Canada, the political stakes and the economic risks will surely remain much smaller than Western Europe's so far as trade with Eastern Europe is concerned. Trade with the USSR of course is quite another matter.

43. The East European reaction to Western initiatives is likely to be mixed, judging from present attitudes, which of course are subject to change. Hungary and Poland, although having the least urgent need for major Western liberalization, are already the leaders in pushing for it. They might in particular welcome Western guarantees for investment, which would eliminate one of the troublesome problems in dealing with potential investors. Romania, currently the most in need of assistance, would certainly take advantage of Western initiatives for longer term credit. Bulgaria is likely to remain the least interested, and Czechoslovakia and East Germany may be expected to remain suspicious of further increases in Western influence in the area.

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SECRET**APPENDIX****STUDIES PROJECTING EAST-WEST TRADE**

Three recent studies projecting East-West trade in the 1970s are mentioned in the text. One, by the UN Economic Commission for Europe, deals with prospects for Soviet and East European exports to Western Europe from 1965-67 through 1980. A second, by Hungarian economists and also issued by the United Nations, projects both imports and exports for the same group of countries from 1955-66 to 1970, 1975, and 1980 in trade with all major areas. A third, published in a Hungarian economic journal, looks at Hungarian imports both from the Communist countries and from the West as inputs into major sectors of final demand, projected from 1953-68 to 1975.

ECE Projection of CEMA Exports to Western Europe

As an example of what might be considered a "demand-pull" formulation for projecting East European exports to 1980, a UN study on intra-European trade shows prospects for East European exports to Western Europe based upon least squares estimates of total imports of 11 industrialized West European countries, in five major commodity groups.¹ These figures are intended only "to illustrate the consequences of extrapolations into the future of certain current tendencies and growth patterns."

Under one assumption, the seven "East European" countries (including the USSR) would retain their 1965-67 market shares for each of five commodity classes in each of 11 West European countries. Export growth from 1965-67 to 1980 would be 8.4% per year, compared with 10% from 1957-59 to 1965-67. An alternative approach postulates "a continuation of the changes in Eastern Europe's market share for five major commodity groups in Western Europe at the same rates as observed between 1957-59 and 1965-67." The resulting growth rate for exports is 10.3%, about as fast as in the earlier period. Neither assumption is intended to reflect anticipated changes in East-West trade patterns, although there will undoubtedly be elements of both stability and change where East European market shares are concerned.

1. Supplement to E/ECE/761/Add. 1, Analytical Report on the State of Intra-European Trade, 12 February 1970. In this study, the Soviet Union is included as part of Eastern Europe, and several non-European members of the industrial West are excluded.

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The alternative projections for 1980 bracket the projection in the text of a 9% average growth in exports, and the range is close to our estimated range of 7.5% to 10.5%. Past and projected Soviet export growth is slower than overall East European growth, bringing the estimates even closer together. But the country projections rank quite differently from those shown in Table 2 in the text, being higher than the range shown there for Czechoslovakia and East Germany and lower for Bulgaria, Poland, and Romania. The UN projections of average annual rates of growth in exports compare as follows with the present ones.

	<i>Percent</i>	
	<i>UN Projections 1965-67 to 1980</i>	<i>Present Projections 1971-75</i>
Bulgaria	7.6	8.15
Czechoslovakia	10.1	5.8
East Germany	10.0	7.9
Hungary	8.5	8.11
Poland	7.5	9.13
Romania	8.5	9.12
USSR	7.8	N.A.

The ECE study assumes much the same trends as the present memorandum for East European exports of major commodity groups (under the assumption of constant market shares): a slowdown in exports of agricultural products (from 10% in the period 1957-59 to 1965-67 to between 4.7% and 5.6% by 1980), less marked declines for mineral fuels (from 8.2% to 7.2%-7.1%) and other minerals and metals (from 10.8% to 7.1%-7.7%), and almost the same high rates of growth for engineering products (from 15% to 13.7%-14.1%) and other manufactures (from 10.2% to 10.7%-11.1%).² The differences between the two sets of estimates reflect the fact that the UN study considers only demand factors; in the present memorandum (and its predecessors) supply factors are also weighed. This on the whole favors countries with the most rapidly growing manufacturing industries, which are (generally) the less developed countries.

Hungarian Trade Network Model

The Hungarian projections of CEMA trade with major areas, prepared in Hungary's Institute for Economic and Market Research, were made with a three-dimensional trade matrix for major commodity groups in 1955,

2. Projecting past changes in shares of the market raises the estimated rates for agricultural products, fuels, and other materials to about the past rates. Such a projection seems less realistic on the demand as well as on the supply side.

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1960, and 1965, using UN data and the RAS methods.³ The flows projected by this method "take into account the shares of world trade in the base period as well as the estimated dynamic growth of the marginal vectors," together with various assumptions introduced as to changes in commodity structure, economic integration in Western Europe, changing trade elasticities, and overall trade trends by major areas. The authors forthrightly recognize the limitations:

The application of structural coefficients gained by ex post computations of periods 5 to 15 years before the projection period is a rather inaccurate method in certain respects. It implies the unrealistic assumption that the factors influencing the trade flows, besides the dimension and substitution effects, will not be different from those between 1955 to 1965. It would be obviously much better to forecast individually or systematically the changes in the structural coefficients, but for doing this, more research, experiments, and information would be needed.

The projections made, however, hold up quite well for 1965-70, giving only slightly higher rates than those actually achieved (12% per year for exports, instead of the 14% achieved; 13% for imports, instead of the actual 12%).⁴ A very sharp deceleration is projected for exports in 1971-75, with a rate of growth of only 7.5%, a much sharper decline in the rate than the range of 7.5% to 10.5% (for Eastern Europe alone) in the present memorandum. The slowdown projected in the Hungarian study reflects abrupt declines in growth rates for exports of fuels, raw materials, machinery, and other manufactures. For the two latter categories, such declines appear out of line with recent developments, and the estimates differ from those in the present memorandum.

The study also projects a slowdown in the growth of imports, to a rate of increase of about 10%. This rate is probably high because the projection does not take into account the debt burdens. In fact, the study projects even more rapidly growing deficits than implied in the present projections,⁵ but without drawing any conclusions.

3. A. Nagy and E. Torok, Two Trade-Flow Models for the Analysis and Projection of International Trade, Part 1: Model A, Trade Network of Six Regions and Six Commodity Classes, St/ECE/MATHECO/1, Vol. I, 16 August 1971.

4. Actual as well as projected figures include the USSR, but projected figures differ, first, in that the imports reflect Western export figures rather than Eastern import statistics and, second, in that Yugoslavia, Greece, Spain, and Turkey are included as partners, along with the developed West.

5. The deficits shown in the Hungarian study are not directly comparable with those calculated for the present study, not only because they cover the USSR as well but also because they reflect Western export statistics, which seriously underestimate East European and Soviet imports.

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SECRET**Study of Hungary's Imports Through 1975**

Perhaps the most interesting of the three studies is one that projects changes in the shares of Hungary's imports, from Communist countries and from the West, in inputs into final demand.⁶ A summary comparison shows the imports as a percent of total (direct and indirect) inputs in 1959, 1968, and the trend projected to 1975, as follows:

	<u>Ruble Imports</u>			<u>Dollar Imports</u>			<u>Total Imports</u>		
	1959	1968	1975	1959	1968	1975	1959	1968	1975
Fixed capital investment	13.1	16.9	18.8	5.4	7.3	10.0	18.5	24.2	28.8
Export	11.5	11.8	13.0	8.5	10.8	11.6	20.0	22.6	24.6
Change in stocks	5.9	9.7	10.6	4.2	11.3	9.1	10.1	21.0	19.7
Consumption	7.3	10.7	11.1	6.3	9.7	12.6	13.6	20.4	23.7
Total final demand	9.5	12.2	13.1	6.4	9.5	11.6	15.9	21.7	24.7

These shares of imports as inputs into final demand, it should be noted, reflect dollar and ruble values converted, not at the official exchange rate (then 11.74 forints to \$1), but at the rates actually used in pricing imports in the domestic economy under the 1968 economic reform (40 forints to 1 ruble and 60 forints to \$1). These rates come much closer to reflecting relative purchasing power than the official exchange rate. They do not seriously distort the relative utility to Hungary of ruble and dollar imports of manufactures, least of all in the case of machinery, although they somewhat overstate the relative value of dollar imports of raw materials. Ruble prices for manufactures are substantially higher and the quality is generally inferior. Paul Marer of Indiana University, who has made the most careful study of the question favors the general use of differential conversion rates in comparing Eastern Europe dollar and ruble imports.⁷

As the tabulation shows, inputs of "dollar imports" -- imports from all Western countries -- into consumption and investment increase much faster than those end uses of GNP, and about the same trend as in 1960-68 is projected for 1969-75. Imports from the West drop, on the other hand, as shares of total inputs into exports and into changes in stocks. Overall

6. Ostvan Orszagh, "A Gazdasag importigenessegrol" (Import Demands of the Economy) *Kuligazdasag*, No. 5, 1972, pp. 336-346.

7. See, for example, Paul Marer, *Estimates of Intradisciplinary and East-West Foreign Trade Prices in East Europe*, IDRC Occasional Paper (Bloomington, Indiana University, 1972).

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dollar imports are shown continuing to grow faster than ruble imports as a result of their rapidly increasing shares of total inputs into consumption and investment.

Furthermore, the share of imports used as direct inputs into final demand, although low in past years, especially for dollar imports (only 20% and 26% were used as direct inputs in 1959 and 1968, respectively), is nevertheless growing rapidly, again especially in the case of dollar imports (the share rising to 34% in 1975). Presumably this shift is accounted for by rapid increases in imports of plant and equipment. In 1968, about two-thirds of all inputs of imports into investment were direct imports. The share is even higher for imports from the West and seems to be rising. Dollar imports have also been increasing rapidly as a share of inputs into the chemical industry, light industry, and food industry, but not into the investment goods industry, which is supported largely and increasingly by imports from Communist countries.

The Hungarian article has been overtaken by events. By 1971, imports from the West had already risen by 81% over 1968, while final demand had risen by only about one-third. Thus the actual increase in the share of dollar imports in inputs into final demand — more than one-third — was greater than the increase of 22% projected by 1975. Machinery imports from the West still contributed somewhat less than the projected share of inputs into fixed capital investment — which also rose rapidly in 1969-71 — but the contribution of dollar imports to consumption was already larger, and the contribution to increases in stocks may have risen rather than fallen.

Hungary has avoided a sharply deflationary policy in the wake of the large trade deficit in 1971, but the future is somewhat uncertain. A small drop in imports from the West was planned for 1972 and probably will be achieved. A fair growth in dollar imports in 1973-75 — 8% to 9% per year — would be needed to regain and maintain the reliance on dollar imports reached in 1971. The leadership may perhaps be satisfied with a slower rise in imports of Western machinery, while absorbing the large imports made in recent years. Inventories will be drawn down. But a further rise in reliance on dollar imports that feed industry and go ultimately into consumption still seems likely. An annual increase of about 7%-8% per year in 1971-75 would appear sufficient. As pointed out in this memorandum, however, Hungary can easily manage for some time to import still more from the West without fearing payments difficulties.

The moral is that even well-made projections based on past trends can be wide of the mark. In this case, actual developments have deviated by moving much faster than projected, as has happened in the case of other projections of East-West trade.